A statement before the
House of Commons Standing Committee
on Finance, Trade and Economic Affairs
by Gerald K. Bouey
Governor of the Bank of Canada
Thursday, November 6th, 1975

Mr. Chairman, I am here today to try to answer any questions your Committee may have about the Bank of Canada's role in the over-all anti-inflation programme. If you would like me to do so I am prepared to make a brief introductory statement.

There is no doubt in my mind that Canada is in serious economic trouble. Our costs and prices have continued to spiral upwards very rapidly in spite of more than a year of recession in this country and a more prolonged and severe recession in the outside world. Two years ago what was happening to prices in Canada was part of a worldwide phenomenon. More recently, however, the trend of costs and prices in a number of the main countries with which we trade has clearly begun to moderate, so that to an increasing extent continuing rapid inflation in Canada is now a special problem of our own.

The policy dilemma posed by this situation is that we can no longer count on being able to reduce unemployment in Canada simply by taking sufficiently strong measures to raise the level of internal demand. There is a very real risk that further stimulation of demand in present circumstances would serve mainly to fuel still higher inflation. As a result, unemployment would remain high; conceivably it too could go still higher.

In my view, it has now become absolutely essential to bring inflation under control in this country if we are to avoid major economic and social damage. This is our only realistic hope of achieving a sound recovery and sustained economic growth. That is why I support the idea of undertaking a concerted programme of measures directed towards this end.

Because the inflationary process in Canada has become so deeply entrenched and has gained such momentum, there is no way of bringing it under control quickly except at very heavy cost in terms of foregone output and lost job opportunities. That is why any drastic move to severely restrictive monetary and fiscal policies has been rejected.

An alternative approach would be to rely on monetary and fiscal moderation alone to slow down the rate of inflation. The problem with such an approach is that it might well take a very long time to succeed, given the fact that we start with such high rates of increase in prices and money incomes, and that the cost in terms of lost employment and output might still be substantial. It might have been a more practicable solution if rates of inflation were not already so high. Nevertheless, in my view a policy of monetary and fiscal moderation can work more effectively and with minimum dislocation if it is supplemented by an effective programme of price and income restraints. With the active support of all Canadians, these restraints can help to ensure that inflation will in fact moderate sufficiently to permit a steady improvement both in job opportunities and in the output of goods and services that we jointly produce and consume.

No one should be in any doubt about what is involved here: with the collective help of all Canadians in bringing inflation under control, we will find ourselves collectively better off, not worse off as many seem to think.

As I have said on previous occasions, there is no great mystery about the nature and origins of our current economic difficulties. Almost all of the world's industrial countries, including Canada, pursued very expansionary monetary and fiscal policies in the early 1970s. The main reason that these policies were adopted was in an effort to restore high levels of output and employment following the economic slowdown at the beginning of the decade.

It was widely believed at the time that until full economic recovery was assured the right course of action for central banks to follow was to resist the tendency for interest rates to rise and credit to tighten even if this involved rapid expansion of the money supply. This was particularly so in countries whose exchange rates were already under strong upward pressure at a time of acute international monetary instability. For many countries the fear that any substantial rise in their exchange rate would greatly complicate their domestic economic problems strongly reinforced the tendency to permit unusually rapid rates of monetary expansion. This was also a consideration of some importance in the monetary policy followed in Canada.

A policy approach of this kind depends of course on an ability to forecast economic developments quite accurately and, having regard to the inevitable time lags, to tighten fiscal and monetary policies substantially well before the limits of the economy's productive capacity are reached. This is not how things turned out. The separate national policies of countries interacted, creating a worldwide inflationary boom of major proportions in 1973 that set off a continuing spiral of very large price and cost increases. Some countries, including Canada, found that their usual measures of unemployment turned out to be highly misleading as a guide to how much room actually existed for further economic expansion. The steep rise in world price levels resulting from the boom was powerfully reinforced by a marked shortfall in the supply of foodstuffs due to poor harvests and by the action of the OPEC countries in quadrupling the price of oil.

The strains and stresses produced by such an overheated economic system take many forms -- a general scramble to build up stocks of particular kinds of goods before they become scarcer and more expensive, a fierce struggle for money income increases large enough to protect the recipients against the effects of price increases that have already occurred or are anticipated, soaring prices, labour costs, interest rates and so on. Established patterns of economic behaviour are distorted by all sorts of imbalances whose eventual reversal is bound to be disruptive and painful. It is no accident that world recession followed hard on the heels of the world inflationary boom, or that a sound basis for renewed and lasting economic growth now seems so difficult to achieve.

I do not propose to dwell longer on the origins of the current problem of inflation. To a considerable extent the causes of the demand-pull inflation are not as immediately relevant to the control of our present inflation as those forces which are keeping it going and even causing it to accelerate. For example, I have stated on another occasion that the current wave of inflation was not initiated by a marked acceleration of wage and salary increases, but because of their relative importance in total costs, very high wage and salary settlements have been a major force behind the continuation of the rise in prices and costs. The objective must be to bring about a deceleration of both price and cost increases.

Besides dealing with this cost-push problem, we must try to manage total demand in the economy better than we have in past cycles. So far as monetary policy is concerned a major change of emphasis seems to me to be occurring in many countries. The experience of recent years has shown how much trouble can be stored up for the future by following a monetary policy that is overly concerned about the short-term impact of interest-rate movements on economic activity or the exchange rate, and not sufficiently concerned with the cumulative effect over time of the rate of monetary expansion on the trend of prices. Experience has, I believe, demonstrated the need for greater steadiness in rates of monetary growth.

Over a two-year period ending in the second quarter of 1973, a period in which unusually high rates of monetary expansion occurred around the world for reasons that I have already mentioned, the public's holdings of currency and demand deposits -- the main forms of money used for making payments in Canada -- increased at an average rate of no less than 15 per cent a year. By comparison, an average rate of about 5 per cent a year would probably have been high enough to accommodate the growth in production of goods and services in Canada at the long-term trend rate if prices had been stable.

The fact is, of course, that over recent years an underlying rate of inflation has been built into our economy which is now much too high to be eliminated at all quickly by suddenly reducing the rate of monetary expansion to anything like such a low figure. The consequences for economic activity would be much too disruptive in the short run, so that whatever progress is to be made in moderating the rate of monetary expansion in Canada must be achieved gradually over time.

Some moderation has occurred. Over the two years ending in the second quarter of 1975, the average rate of growth of currency and demand deposits in Canada was down to about 10 per cent a year. During the summer months the rate of growth of the money supply so defined bounced back up to unusually high figures, but the Bank has since taken action -- culminating in the Bank Rate increase early in September -- in an attempt to deal with that situation.

I should point out that the technical means available to the Bank of Canada for slowing down the growth of the money supply so defined is to restrict the quantity of cash reserves it makes available to the banking system in its day-to-day operations. The effect is to slow down the rate at which the banking system expands and this puts upward pressure on short-term interest rates. Higher short-term interest rates affect the willingness of the public to hold money in non-interest bearing forms. I want to stress the key role played in this matter by higher short-term interest rates, which from time to time will include the Bank of Canada's own lending rate, the Bank Rate.

How strong an impact such action by the Bank of Canada will have in slowing the growth in the months ahead of currency and demand deposits will depend in part on the strength of the other major determinant of the demand for money balances, that is, the level of total spending in the economy. The Bank of Canada is, however, able to exercise a broad controlling influence over the underlying trend of monetary expansion -- not from week to week or even, necessarily, from month to month, but certainly over periods long enough for the behaviour of the economy to be significantly affected by the trend of the money supply.

In exercising this influence, the Bank of Canada tries to avoid over-reacting to the wide variations in the rate of monetary growth that can -- and frequently do -- occur over relatively short periods of time. In most cases these variations are the result of transient and essentially self-reversing disturbances of only a few weeks' duration. If the Bank of Canada reacted sharply to every temporary spurt or pause in the growth of currency and demand deposits, its actions would necessarily involve much larger, more frequent and more disruptive changes in interest rates than would serve any useful economic purpose.

The broad objective that the Bank of Canada continues to pursue is, as I have stated elsewhere, to maintain enough monetary growth to support rising levels of economic activity together with a moderation of the rate of inflation.